United States Court of Appeals

for the Second Circuit

BRIEF FOR APPELLANT

ORIGINAL

76-5004

United States Court of Appeals
FOR THE SECOND CIRCUIT

B

ALAN B. MILLER, as Trustee in Bankruptcy of AMERICAN IBC CORP., Bankrupt,

Plaintiff-Appellee,

against

P/S

WELLS FARGO BANK INTERNATIONAL CORP.,

Defendant-Appellant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT, FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF APPELLANT WELLS FARGO BANK INTERNATIONAL CORP.

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BRIEF OF APPELLANT WELLS FARGO BANK INTERNATIONAL CORP.

Issues

1. Was the district court in error in holding that the first loan Wells Fargo Bank International Corp. made to American IBC Corp. was unsecured by either an assignment or a pledge of a time deposit at Wells Fargo, Luxembourg, when the communications between those banks specified it was to be held as collateral for that loan?

2. Was the district court in error in holding that Wells Fargo Bank International Corp. lost its security interest in the pledged Luxembourg time deposit when Wells Fargo, Luxembourg, sent the proceeds on November 19, 1973 to Swiss Credit Bank for the purpose of conversion into dollars to be sent through the international clearing process to Wells Fargo Bank International Corp.?

3. Was the district court in error in holding that repayment to Wells Fargo Bank International Corp. on November 19, 1973 of the second loan diminished the assets of the bankrupt's estate when the funds used to repay the loan were effectively the property of Swiss Credit Bank?

4. Was the district court in error in holding that Wells Fargo Bank International Corp. had "reasonable cause to believe" that American IBC Corp. was insolvent when it concededly had no actual knowledge of insolvency and the facts relied on by the court were known to the bank before the loans were made?

Statement of the Case

This is an appeal from a judgment of the United States District Court for the Southern District of New York rendered by Judge Milton Pollack and entered on January 8, 1976. The judgment directs that Alan B. Miller, a

partner of Weil, Gotshal & Manges, as Trustee in Bankruptcy of American IBC Corp. ("AIBC"), shall recover from Wells Fargo Bank International Corp. ("the New York Bank"), as a voidable preference, the sum of $2,084,583.34 (plus interest) representing the aggregate amount the New York Bank received on November 2, 1973 and November 19, 1973 in repayment of loans made by the New York Bank to AIBC on May 3, 1973 and May 17, 1973, respectively.

Preliminary Statement

The two transactions involved in this case are essentially the reverse of the classical fact pattern where a borrower seeks to prefer his favorite lender within the four month period prior to bankruptcy. As all the elements of each transaction were established at the outset it was unnecessary for the debtor to do anything between the time the loan was made and the time it was to be repaid. All of the instructions were given at the inception so that the transactions would unwind and self-liquidate automatically. The first transaction was fully secured and unwound in accordance with the initial instructions.

With respect to the second transaction, AIBC and the New York Bank intended and agreed that the transaction was to be secured as in the first. There were, however, certain differences. The time deposit was not lodged with the Luxembourg affiliate but with United California Bank ("UCB") although it was physically on deposit with Swiss Credit Bank ("SCB"). At some point after the transaction was entered into, Sheldon Silverston ("Silverston"), the President and principal owner of AIBC, realized that he might be able to turn the difference in the documentation in the second transaction to his personal advantage.

AIBC had borrowed other funds from SCB, and Silverston had personally guaranteed the loan. In an apparent effort to avoid personal liability to SCB, Silverston arranged to convert the New York Bank's collateral. He

irrevocably ordered UCB to pay the proceeds of the time deposit to SCB at maturity (which SCB already had in its possession). He then authorized SCB to utilize the dollars (into which the Swiss franc proceeds of the UCB time deposit were to be converted on November 19) to repay the SCB loan which he had personally guaranteed. At the maturity date (November 19, 1973), SCB received the Swiss franc proceeds of the UCB time deposit and converted them to dollars. Instead of repaying its own loan, however, it transmitted those funds to the New York Bank for some unexplained reason.

As far as the New York Bank knew, both transactions had unwound automatically. The record clearly establishes the fact that the New York Bank had no reason to believe that AIBC was insolvent until after the repayment of the second loan.

Statement of Facts

The Relationship Between The New York Bank and AIBC

The record is clear that, as a matter of banking policy, the New York Bank would not have dealt with AIBC even on a secured basis, if it believed that AIBC was insolvent. [Trial transcript ("Tr.") pp. 189, 190, 266] Typically the New York Bank dealt with AIBC on an "offering" basis. AIBC would propose transactions to the New York Bank. If the New York Bank felt the transaction made economic sense and that its participation in the transaction would be secured, it would participate. The New York Bank participated in some 16 back-to-back letters of credit transactions with AIBC. AIBC never sought or obtained credit itself; it functioned essentially as a broker in structuring the transactions. [Tr. pp. 249-250]

The New York Bank had general internal credit procedures to keep itself informed about AIBC's financial status. These procedures included the preparation of internal credit reports, called CR 38 and 39 reports. [J.F.F. *79

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* The Joint Findings of Fact is referred to as "J.F.F."

(A* 31); Exs. 54 (E** 166), 26 (E 73); Tr. pp. 255-58]. The New York Bank checked periodically with other banks with whom AIBC had a relationship. It maintained a subscription to Dun & Bradstreet reports. [Ex. I-M (E187-E192)] It also obtained a copy of AIBC's annual financial statement. [Ex. 50 (E 128)]

None of these sources of information reflected adversely on AIBC's financial position until well after the last loan was repaid. They did not reveal AIBC's problems in the foreign exchange field. They did not reveal its lawsuit with United Brands. They also did not indicate that some of AIBC's bank accounts had been attached. [Ex. AL (Lilien Deposition) pp. 64-67, 73-78]

The New York Bank Did Not Have Reasonable Cause To Believe That AIBC Was Insolvent

The district court based its holding that the New York Bank had reasonable cause to believe that AIBC was insolvent on the following grounds: first, the court found that AIBC was thinly capitalized with a net worth of only $105,000. [Opinion, A 130] Second, the court found that the New York Bank knew that AIBC was in danger of losing $3,000,000 and that knowing this it proceeded to lend AIBC $2,000,000. [Opinion, A 130]

Apart from the correctness of the district court's finding to this effect, its legal conclusion that the New York Bank had reasonable cause to believe AIBC was insolvent is not supported by the district court's own findings of fact.

In 1972, AIBC acquired a number of assets in Colombia which were reflected in its 1972 financial statement at a valuation of approximately $3,000,000. The assets consisted of Cedulas (similar to United States Treasury bills), land, a bank, and other investments. United Brands (formerly named United Fruit) through its subsidiary, Sevilla

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* The Joint Appendix is referred to as "A" followed by the page number in the Joint Appendix.

** The Exhibit Volume accompanying the Joint Appendix is referred to as "E" followed by the page number in the Exhibit Volume on which the Exhibit is located.

de Frutera (United Fruit Colombia), loaned approximately $3,000,000 to IBC, Colombia. AIBC guaranteed the loan. AIBC apparently made its investments in South America using these funds [Ex. 50 (E 128)]. Presumably, ownership of the investments would carry the obligation to repay the $3,000,000 loan. [Tr. pp. 46, 47]

According to AIBC's financial statement, these assets were its property. The New York Bank had no reason to believe that they were not. However, many of these investments were operated as Colombian entities in the nominee names of Luis Lara ("Lara") and Gonzalo Ospina ("Ospina") because Silverston felt it would be wise for AIBC to keep a low profile as a foreign investor. [Opinion, A 130]

In early 1973 Silverston was informed that Lara and Ospina were claiming some of these assets belonged solely to them, not AIBC. [Tr. p. 109] Silverston had responded that he, Lara and Ospina should be considered as one.*

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* "I think I should further comment on the relationship between Luis and Gonzalo and myself. Obviously Luis and Gonzalo are related by marriage. Where does Silverston come in? I consider Luis and Gonzalo as part of the Silverston family. Helene (and me too) has the same feeling for Inez and Liliana. Without expression and words Gonzalo and Luis, I hope Inez and Liliana have the same feeling for Helene and myself. We, Gonzalo or Luis or myself, speak for each other. You are aware I am sure that Gonzalo and Luis are both officers of American IBC Corp. What Luis or Gonzalo says or commits to is a commitment by me and what I say is a commitment by Luis or Gonzalo. What I am trying to portray is that we are basically interchangeable. There are no other two men in the world in whom I have so much faith and trust.

"This goes further than business sense, this is a personal sense. As you know, talk is cheap. Much gossip and rumors we just disregard. However, the rumor mongers in Bogata certainly touch a sensitive point when untrue and damaging allegations are made. I sincerely doubt that Gonzalo ran around Bogota and said he bought Banco Nacional. I have not discussed the point with him, but if he did it is all right with me because, as I said above, whatever commitments and statements are made either by Gonzalo or Luis with regard to IBC I think I will stand behind." [Tr. pp. 109-12; Exs. AF (E 223) AG (E 229)]

In early 1973, Silverston told Mr. William Boland, the Vice President of the New York Bank in charge of AIBC's account ("Boland"), that he was having a problem with the "Lara Group" with respect to assets in Colombia. Boland suggested that Silverston retain a lawyer. Silverston said that he had done so and was now trying to arrange a settlement. [Tr. p. 163]

It is clear from the record (and the fact that the New York Bank subsequently lent AIBC $2,000,000) that Boland did not think this dispute between Silverston and the Colombian partners had a significant impact on AIBC's financial picture. [Tr. p. 151] There is nothing in the record to suggest that Boland knew that Lara and Ospina had converted these assets from AIBC or that they had succeeded in misappropriating them without assuming the offsetting obligation to United Brands. As far as Boland knew, AIBC was still in possession and control of its Colombian assets. Finally, in light of Silverston's relationship with Lara and Ospina, Boland had every reason to believe that any dispute that might exist between them could be resolved.

Subsequently, on May 1, 1973, Silverston sent Boland a letter asking the New York Bank to act as escrow agent pursuant to an agreement among AIBC, Lara and Ospina. The New York Bank did not agree to act as escrow agent since it was thinly staffed and not geared to handle such a transaction. [J.F.F. 65 (A 28); Tr. p. 159; Ex. 15 (E 24)]

Again there was nothing in this letter to indicate that Lara and Ospina had converted assets belonging to AIBC or that they had misappropriated any assets belonging to AIBC leaving AIBC with the offsetting obligation to United Brands.* Silverston testified that the proposed settlement was something AIBC could "survive with and

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* In fact, as the court acknowledged, the proposed settlement, as revealed by other documents, would appear to balance out. AIBC would release some of its assets to Lara and Ospina. In return, United Brands would release AIBC from its guarantee of United Brand's $3,000,000 loan to IBC, Colombia. [Opinion, A 176; Ex. 50 (E 128)]

continue on with." [Tr. p. 50] Obviously, AIBC could not have survived a $3,000,000 loss.

It is apparent from the record that Boland did not know or have reason to suspect the underlying terms of the settlement or the magnitude of the problem. [Tr. pp. 158-59] The record clearly demonstrates that the New York Bank believed that AIBC was a viable and financially stable organization in which it had complete confidence. For this reason, in May, 1973, the New York Bank proceeded to lend AIBC $2,000,000.

The New York Bank demonstrated its eagerness to investigate information that reflected on AIBC's financial status in July, 1973. At this time, Mr. Charles Lilien, the Executive Vice President of the New York Bank ("Lilien"), learned that AIBC was having difficulties with Banco de la Republica in Colombia over a "switch" transaction. Lilien instructed Mr. Gustavo Arango, a representative of Wells Fargo, N.A., in Colombia ("Arango") and Boland to investigate the matter and report back to him.* As a result of this investigation, the New York Bank was satisfied that AIBC was a responsible and effective company and was able to carry out its functions as a broker in international transactions. Because of this continued belief in AIBC's viability and expertise, in late October, 1973, Mr. Nikita Lobanov, a Vice President of the New York Bank ("Lobanov") recommended AIBC and Silverston to Sunkist Growers, Inc., a client of the New York Bank for the purpose of having AIBC enter into "switch" transactions on behalf of Sunkist. [Opinion, A 178 n. 8; J.F.F. 60 (A 27); Tr. pp. 343-44] The New York Bank would not have made such a recommendation if it had reason to believe that AIBC was insolvent.

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* In addition, he noted that the bank should avoid any new transactions with AIBC until the matter was resolved. [J.F.F. 71, 72 (A 29); Ex. 29 (E 85); Tr. p. 298] Subsequently, both Arango and Boland reported that the matter had been satisfactorily resolved. [J.F.F. 73 (A 30); Tr. pp. 184-86, 298; Exs. W (E 210), Y (E 215); Ex. AL (Lilien Dep.) pp. 69-71] In addition, Silverston sent a copy of a telex from Banco de la Republica to the New York Bank which indicated that the matter was settled. [Opinion, A 129; Ex. X (E 211)]

Between October 31, 1973 and November 15, 1973 the New York Bank compiled and forwarded to its parent company, Wells Fargo Bank, N.A., a routine credit report on AIBC. [J.F.F. 78, 79 (A 31)] At the time the report was compiled, the New York Bank had Dun & Bradstreet's regular reports on AIBC, the most recent of which was dated October 3, 1973.* None of the reports covering 1973 mentioned any litigation against AIBC, or any losses, or any other matters affecting AIBC's financial position or ability to pay its bills. Also, on or about November 9, 1973, the New York Bank made routine inquiries of four banks which had done business with AIBC. Three of these banks had been served with orders of attachment in the *United Brands* case. The New York Bank was not aware of the attachments. None of the banks contacted mentioned the attachments or made any other mention of litigation against AIBC. [Opinion, A 128-29; Exs. I-M (E 187-E 192)]

On November 2, 1973 and November 19, 1973 payments from SCB to the New York Bank completed the two transactions. In each case, the payment occurred on the exact date and in the exact manner specified in the original contract documents. [Opinion, A 122, 128-29] After repayment of the second loan on November 19, 1973, Boland met Silverston for lunch. Boland was aware that the transactions "packaged" by AIBC had been completed. He was anxious to arrange more business between the New York Bank and AIBC. [J.F.F. 58 (A 26); Tr. pp. 169-70]

At lunch, Silverston proposed a new transaction in the Dominican Republic which he wished the New York Bank to finance. [Tr. pp. 176-77, 189] As the Dominican Repub-

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* It also had several special reports forwarded automatically during the year by Dun & Bradstreet to report current developments since the last regular report. One such Dun & Bradstreet report dated April 28, 1971 did report on some minor litigation against AIBC involving some $2,000. The only other litigation involving AIBC ever reported by Dun & Bradstreet was the filing of the petition in bankruptcy in January, 1974, long after the loans were repaid.

lic lay outside of Boland's geographic area of responsibility, Boland suggested that Silverston meet with Mr. Robert Van Veersen ("Van Veersen"), who was in charge of that area. [J.F.F. 58 (A 26); Tr. pp. 178-80]

Boland did not suspect, let alone have reasonable cause to believe, that AIBC was insolvent. Had he suspected that AIBC was insolvent, he would never have arranged Silverston's meeting with Van Veersen. [Opinion, A 178 n. 8; Tr. pp. 189-90] At the end of the day, Boland was completely satisfied with the New York Bank's relationship with AIBC. [Tr. p. 180]

Only After November 19, 1973 Did The New York Bank Begin To Suspect, And Later Believe, That AIBC Was In Financial Difficulty

On November 20, 1973, Silverston arrived at the New York Bank for a luncheon meeting with Van Veersen. While Silverston was waiting for Van Veersen, he met Lobanov in the lobby and had a brief conversation with him. [Tr. p. 344] Lobanov asked Silverston why he had not followed up the Sunkist matter for which Lobanov had recommended AIBC in October. Silverston responded that his difficulties in Latin America were taking his time and that the Laras "might be taking" him for $5,000,000. [Tr. p. 345] The next day, Lobanov wrote Sunkist to tell it that AIBC was currently in financial difficulty; and he recommended two other companies which handled "switch" transactions. [J.F.F. 61 (A 27); Ex. 25 (E 72); Tr. p. 343]

Silverston and Van Veersen had their luncheon meeting immediately thereafter. Silverston explained his new Dominican Republic proposal which involved the New York Bank financing the sale of Yugoslavian motorcycles to policemen in the Dominican Republic. Van Veersen and Lilien subsequently decided that the New York Bank was not interested in this type of proposal, and Van Veersen informed Silverston of the decision a few days later. Their rejection of the proposal had nothing to do with the financial condition of AIBC. [Tr. pp. 356-60] Van Veersen did not suspect that AIBC might be insolvent. [Tr. p. 359]

On December 5, 1973, the New York Bank received a telex from SCB. In this telex, SCB claimed that it had transferred the $1,046,894.05 to the New York Bank on November 19, 1973 by mistake and that, in fact, these funds had been assigned by AIBC to SCB. [Ex. N (E 193)] Boland then telephoned Silverston. Silverston told Boland that SCB was mistaken; SCB did not know what it was doing; and it had confused the New York Bank's funds with other AIBC funds. [Tr. p. 191]

As a result of an exchange of further telexes between the New York Bank and SCB [Exs. O-R (E 194-E 197)], Lilien called Silverston on December 11, 1973. Silverston again said that SCB was mistaken. He told Lilien that AIBC had pledged other funds to SCB, not the New York Bank's collateral; and the funds received by the New York Bank on November 19, 1973 clearly belonged to it. [Tr. pp. 264, 265] At this time, Silverston did tell Lilien that AIBC was having financial difficulties. [Ex. S (E 198)] As a result, Lilien wrote the following memo:

> "THIS FIRM IS IN SERIOUS FINANCIAL DIFFICULTY.
>
> REFER NO BUSINESS TO THEM OR TO SILVERSTON.
>
> EXTEND NO CREDIT.
>
> ALLOW NO OVERDRAFTS.
>
> REFER ALL MATTERS CONCERNING THE NAME DIRECTLY TO C. E. LILIEN." [Ex. T (E 205)]

Subsequent negotiations followed with Weil, Gotshal & Manges, as counsel for SCB, seeking the return of the funds. The New York Bank refused to return them.

The First Loan Transaction

In a telephone conversation between Silverston and Boland, confirmed by a letter from Silverston to Boland dated April 30, 1973 and by a reply letter from Boland

to Silverston dated May 2, 1973, AIBC proposed, and the New York Bank agreed to, the first loan transaction.*

The transaction was profitable for AIBC because of the exchange rate differential between the Swiss francs and the dollars—3.24 "spot" and 3.173 six months "forward". The "spread" between "spot" and "forward" rates was great enough to cover the excess of the interest AIBC paid on its loan from the New York Bank, as against the interest it received on the time deposit. Without using any of its own funds, AIBC made a profit of $2,369 which it basically earned at the outset. [Opinion, A 174 n. 1; J.F.F. 18 (A 18)]

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* (1) AIBC would borrow $1,000,000 from the New York Bank on May 3, 1973. Interest on the loan was to be at 8 percent, calculated on a 360-day basis; and the loan was for a period of 182 days. AIBC instructed the New York Bank to deliver the $1,000,000 to Chase Manhattan Bank to be credited to the account of SCB, reference AIBC Corp. At the same time, AIBC contracted with SCB to sell the $1,000,000 borrowed for 3,240,000 Swiss francs (at the rate of 3.24 Swiss francs to one U.S. dollar);

(2) AIBC instructed SCB to deliver the 3,240,000 Swiss francs to the account of the Luxembourg affiliate, located at Swiss Bank Corporation. The 3,240,000 Swiss francs were placed in an interest-bearing time deposit which was to mature on November 2, 1973. AIBC agreed with the New York Bank that this time deposit was collateral security for the New York Bank's loan;

(3) AIBC contracted with SCB to sell 3,308,850 Swiss francs to SCB for delivery on November 2, 1973 for $1,042,814. The 3,308,850 Swiss francs were the equivalent of the proceeds of the principal and interest on the Swiss franc time deposit at its maturity on November 2, 1973. The rate of exchange on this "forward" sale of Swiss francs for dollars six months in the future was 3.173 Swiss francs for one U.S. dollar;

(4) AIBC asked the New York Bank to direct its Luxembourg affiliate to deliver the 3,308,850 Swiss francs through Swiss Bank Corporation, Zurich, to SCB on November 2, 1973. AIBC instructed SCB to deliver the $1,042,814 to the New York Bank on November 2, 1973; and

(5) AIBC and the New York Bank agreed that when SCB delivered the $1,042,814 on November 2, 1973, to the New York Bank, the New York Bank would pay itself $1,000,000, and $40,444 in interest. AIBC's account was to be credited with the difference of $2,369. The latter sum was AIBC's profit on the transaction. [Opinion, A 174 n. 1; Exs. 1 (E 1), A (E 174)]

In the letter to the New York Bank confirming the first loan, AIBC stated that the deposit at the Luxembourg affiliate was to be collateral security for the loan. [Ex. 1 (E 1)] The Luxembourg affiliate was informed by the New York Bank that the deposit was collateral for the loan and held the time deposit as the New York Bank's agent. [Opinion, A 139; Ex. H (E 185)] When the Luxembourg affiliate delivered the proceeds of the collateral deposit to SCB on November 2, 1973, it did so with express instructions that they were to be converted into dollars, which were then to be forwarded to the New York Bank. [Opinion, A 174 n. 1; Ex. 60 (E 173); J.F.F. 19 (A 18)]

The Second Loan Transaction

Shortly after the May 2, 1973 loan, Silverston called Boland and proposed a second arbitrage transaction similar to the first [J.F.F. 28 (A 20); Opinion, A 157]. The New York Bank agreed to lend AIBC $1,000,000 under similar conditions as the first loan. Silverston sent a letter to the New York Bank in which he outlined those aspects of this transaction that would differ from the the first transaction, principally the interest rate and location of the time deposit. [Ex. 9 (E 11)]

The intended location for the collateral time deposit was UCB rather than the Luxembourg affiliate. Actually, the funds never left SCB; they were simply credited to an account at SCB in the name of UCB. [Opinion, A 157, 174 n. 1; J.F.F. 29 (A 20)]

SCB had complete control over the funds in the time deposit. Prior to June 15, 1973 and through July of 1973, SCB exchanged letters and telexes with AIBC and UCB to confirm that AIBC's instructions to UCB to deliver the proceeds of the collateral time deposit to SCB upon maturity were irrevocable. On August 29, 1973, AIBC (at SCB's request) instructed SCB to utilize the dollar proceeds of the second forward foreign exchange contract (the dollars that AIBC was to receive for selling the Swiss franc proceeds of the UCB time deposit) "to repay all dollar advances (and interest thereon) made to AIBC

Corp." [Exs. 19 (E 41), 40 (E 111); Opinion, A 163, 168] For some unexplained reason, SCB did not use the funds to pay itself but sent them to the New York Bank.

Again, the transaction "unwound" automatically.* At 11:22:07 a.m. on November 19, 1973, the New York Bank received $1,046,894.05 through the New York Clearing House from Chase Manhattan Bank. The New York Bank credited AIBC's account with $1,046,894.05 and simultaneously debited AIBC's account in the amount of $1,043,916.67 (the principal and interest due for the 196-day period), leaving $2,977.38 in AIBC's account, which constituted AIBC's profit on the transaction. [Opinion, A 174 n. 1; J.F.F. 51 (A 25)]

On December 5, 1973, about two and one-half weeks after the second loan was repaid, SCB telexed the New York Bank and advised it that the $1,046,894.05 paid to the New York Bank on November 19, 1973 was sent by mistake. [Ex. N (E 193)] SCB said that those funds had been assigned to it in August, 1973 by AIBC. It was only after the exchange of telex and telephone messages in December, 1973 that the New York Bank realized that Silverston had tried to convert the New York Bank's collateral to relieve himself of personal liability to SCB and his personal guaranty of SCB's advances to AIBC. [Tr. pp. 265-66]

ARGUMENT

POINT I

The first loan was secured by assignment of the time deposit located at the Luxembourg Affiliate.

It is settled law that payment of a secured claim does not constitute a preference. *Bachner* v. *Robinson,* 107 F.2d 513 (2d Cir. 1939). A security interest in a bank deposit may be acquired either by an assignment *or* by a pledge of the account. [Opinion, A 137, 145] *Walton* v.

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* The transaction was intended to be a secured, self-liquidating transaction. [Tr. 370]

Piqua State Bank, 204 Kan. 741, 757, 466 P.2d 316, 329 (1970). In the present case, the New York Bank received from AIBC for security both an assignment and a pledge of a time deposit located at the Luxembourg affiliate. The deposit was assigned by the April 30 and May 2, 1973 exchange of letters between AIBC and the New York Bank. [Exs. 1 (E 1), A (E 174)] The pledge consisted of the lodging of the time deposit with the Luxembourg affiliate as the New York Bank's agent. (For discussion of the pledge, see Point II, *infra.*)

A. The District Court Properly Held That Under New York Law An Assignment Of A Bank Deposit Is Perfected When Made Against Subsequent Lien Creditors Or A Trustee In Bankruptcy Without Notice To The Obligor Bank Holding the Time Deposit

Time deposits as choses in action are assignable. [Opinion, A 145] *See also* N.Y. Gen'l Oblig. Law, § 13-101 (McKinney's, 1964); *Myers* v. *Albany Savings Bank,* 270 App. Div. 466, 60 N.Y.S.2d 477 (3d Dep't), *aff'd,* 296 N.Y. 562, 68 N.E.2d 866 (1946); *Walton* v. *Piqua State Bank,* 204 Kan. 741, 757, 466 P.2d 316, 329 (1970).

Under New York law,* an assignment of a chose in action is perfected when made.** Notice of the assignment

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* State law governs the question of whether a bank has a security interest in the property alleged to have been received as a voidable preference. [Opinion, A 136] *See also McKenzie* v. *Irving Trust Co.,* 323 U.S. 365, 370 (1945). The parties have agreed that the law of New York should control in connection with any transactions between the New York Bank and AIBC. [Opinion, A 136]

** It is clear that the New York Uniform Commercial Code ("U.C.C.") does not govern the transfer of a security interest in a bank deposit. The U.C.C., § 9-104(k) (McKinney's, 1964) provides:

> ". . . This article does not apply,
>
> (k) to a transfer in whole or in part of any of the following; any claim arising out of tort; *any deposit, savings, passbook or like account maintained with a bank,* savings and loan association, credit union or like organization." [Emphasis supplied] [See Opinion, A 145]

is not necessary to perfect the assignee's security interest against subsequent lien creditors or a trustee in bankruptcy.* [Opinion, A 145] *County National Bank* v. *Inter-County Farmers Coop. Ass'n.*, 65 Misc.2d 446, 317 N.Y.S.2d 790 (Sup. Ct. 1970); 3 N. Y. Juris., *Assign.*, § 40, p. 301 (1958); *Rockmore* v. *Lehman*, 129 F.2d 892 (2d Cir. 1942), *cert. denied*, 317 U.S. 700 (1943); 3 Collier on Bankruptcy ("Collier") ¶ 30.48 at 1018 n. 8 (14th ed. 1974). Notice is only necessary in order to protect the assignee from a good faith payment by the obligor (*e.g.*, a bank) to the assignor (*e.g.*, a depositor). [Opinion, A 183 n. 18] *Myers* v. *Albany Savings Bank, supra; Brown* v. *Empire City Savings Bank*, 23 Misc.2d 1094, 203 N.Y.S.2d 339 (Sup. Ct. 1960).** Nor does the assignee need "possession" of the obligation underlying the chose in action. [Opinion, A 145] *See* 3 Williston on Contracts, § 430 at 172 (3d ed. 1960); 3 N. Y. Juris., *Assign.*, § 3 (1958).

Therefore, the only question is whether AIBC made an assignment of the Luxembourg time deposit to the New York Bank. The district court found that while the April 30 and May 2, 1973 letters transferred to the New York Bank a security interest in the time deposit [Opinion, A 151] they did not constitute an assignment.

B. The April 30 And May 2, 1973 Letters Constituted A Valid Assignment Of A Security Interest In The Luxembourg Time Deposit To The New York Bank

An assignment "is a transfer or setting over of property or of some right or interest therein, from one person to another . . ." *Griffey* v. *New York Central Insurance Co.*, 100 N.Y. 417, 422, 3 N.E. 309, 311 (1885); 6A C.J.S. *Assignments*, § 2 (1975); Restatement of Contracts,

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* The district court found that the New York Bank did in fact give notice to its Luxembourg affiliate. [Opinion, A 139]

** The New York Banking Law, § 238(3), does require that the assignee give notice to the bank if the assignee wishes to hold the bank liable for improper payment to another party. This section does not require notice to perfect a security interest against subsequent lien creditors. *See United States* v. *Bowery Savings Bank*, 297 F.2d 380 (2d Cir. 1961).

§ 149(1) (1932). An assignment may be either outright or for the limited purpose of security with title remaining in the assignor.* *Maloney* v. *John Hancock Mutual Life Insurance Co.*, 271 F.2d 609 (2d Cir. 1959); *Malone* v. *Bolstein*, 151 F. Supp. 544 (N.D.N.Y. 1956), *aff'd*, 244 F.2d 954 (2d Cir. 1957); *Fairbanks* v. *Sargent*, 117 N.Y. 320, 332, 333 (1889); *In re City of New York*, 197 Misc. 154, 95 N.Y.S. 2d 26 (Sup. Ct. 1950); 3 N.Y. Juris., *Assign.*, § 50 (1958).

In *Maloney* v. *John Hancock Mutual Life Insurance Co.*, *supra*, this court recognized that an assignment may be for the purpose of securing a loan.

> "[N]umerous decisions of this circuit recognize the validity of conditional assignments under New York law. Such opinions recognize as an effective present assignment, *a transfer by way of security* for a loan of claims to become payable in the future, when the

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* No special form or words are necessary to effect an assignment in the absence of statutory provisions prescribing a particular mode or form. *Advance Trading Corp.* v. *Nydegger & Co.*, 127 N.Y.S.2d 800, 801 (Sup. Ct. 1953); *Estate of Palmer*, 53 Misc. 2d 217, 278 N.Y.S.2d 352 (Sur. Ct. 1967); 3 N.Y. Juris., *Assign.*, § 28 at 284 (1958). Any language, however informal, if it shows the intention of the owner of the chose in action to transfer it, will be sufficient to vest the property in the assignee. *Adams* v. *Garzillo*, 155 Misc. 358, 279 N.Y.S. 398 (Mun. Ct. of N.Y.C. 1935); 3 N.Y. Juris., *Assign.*, § 28 at 284 (1958). In determining whether an intention to assign exists, the form of words used in making the agreement is not alone to receive attention; rather all the circumstances of the transaction are to be considered. *Williams* v. *Ingersoll*, 89 N.Y. 508 (1882); *Estate of Palmer*, 53 Misc. 2d 217, 278 N.Y.S.2d 352 (Sur. Ct. 1967). The use of the word "assign" is not an essential element of a valid assignment. *Williams* v. *Ingersoll, supra; In re Estate of Boissevain*, 40 Misc.2d 237, 243 N.Y.S.2d 36 (Sur. Ct. 1963); 3 N.Y. Juris., *Assign.*, § 28 at 284 (1958). *See* Opinion, A 146.

The district court's suggestion that the test for the existence of an assignment is more stringent than the test for the existence of a pledge is not supported by any cited authority and is misleading. In *Cosmopolitan Film Distributors, Inc.* v. *Feuchtwanger Corp.*, 226 N.Y.S.2d 584, 587, 591 (Sup. Ct. 1962) an assignment for purposes of "collateral security" was found to exist even though the delivery requirement necessary for a pledge was not present.

> transfer is conditioned upon the assignor's default in repayment of the loan . . ." *Id.* at 614. [Emphasis supplied]

In the present case, the district court failed to recognize that an assignment may be for security purposes with title remaining in the assignor. [Opinion, A 151] It was this critical error which lead the district court to find that the April 30 and May 2, 1973 letters* did not constitute an assignment.

In the letter dated April 30, 1973, [Ex. 1 (E 1)] from Silverston to Boland, Silverston stated:

> "We confirm to you our borrowing from you and *lodging with you as collateral* for such borrowing, a Swiss Franc time deposit, as detailed below . . .
>
> This Swiss Franc sum is placed on time deposit value May 3, 1973 until November 2, 1973 at an interest rate of 4.25% per annum. *This deposit is lodged with you as collateral* for the One Million Dollar Loan and is subordinated to such loan." [Exhibit 1 (E 1)] [Emphasis supplied]

In a reply letter to Silverston dated May 2, 1973, Boland stated:

> "*You have agreed to lodge with us as collateral* the Swiss Franc time deposit as outlined in your letter dated April 30, 1973." [Exhibit A (E 174)] [Emphasis supplied]

Clearly these letters resulted in a transfer of a security interest in the time deposit to the New York Bank. [Opinion, A 151] As such, they constituted an assignment under New York law.**

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* These letters formed the basic agreement between the parties.

** The appellant argued below that if the district court found that a pledge did not exist because of the lack of an indispensable instrument the creation of a security interest as evidenced by the

(footnote continued on following page)

Griffey v. *New York Central Insurance Co., supra,* involved language virtually identical to that in the present case. In *Griffey,* a debtor deposited insurance policies with a bank as collateral security for a loan. The policies were pledged by delivery to a bank. In addition, the debtor executed the following assignment:

> "We hereby transfer the following assurance policies, amounting to $16,000, to the Lewisburg National Bank, *as collateral security* for claims said bank holds against us, and that in case of loss by fire to any of our properties insured in following companies, shall be payable to said Lewisburg National Bank, as their claim against us may appear." 100 N.Y. at 418. [Emphasis supplied]

Subsequently, the debtor brought an action to collect on the policy. The insurance company defended on the ground that the policy prohibited assignments. The court held the prohibition only included outright assignments and not pledges or assignments for security as was the case here. 100 N.Y. at 416-18.

In *Frensdorf* v *[illegible]mpf,* 30 N.Y.S.2d 211 (Sup. Ct., 1941), the court considered the effect of an apparent outright assignment of a mortgage and a letter of the same date which read as follows:

> "I hand you herewith the following security *to be*

(footnote continued from preceding page)

letters must be considered an assignment. This contention is in complete accord with the Restatement of Security. The Comment to § 2(3) at p. 14 states:

> "If an interest is created in an intangible, not represented by an indispensable instrument, it is considered a security assignment rather than a pledge."

This position is in accord with New York case law which treats a written agreement transferring a security interest as an assignment. The subsequent delivery of the collateral constitutes the pledge. *Fairbanks* v. *Sargent, supra; Griffey* v. *New York Central Insurance Co., supra; Cosmopolitan Film Distributors, Inc.* v. *Feuchtwanger Corp., supra. See also In re Mile Hi Restaurants Inc.,* 233 F. Supp. 936 (D. Col. 1964). The district court rejected this argument without citing any authority. [Opinion, A 176 n. 4]

pledged as general collateral to any and all loans direct or indirect and any and all renewals thereof:

> $15,000. Assgt. 1st B/M—John B. Uhle William C. Kramer to S. Frensford on property—410-14 Canal St. and 617 E. Erie Blvd." *Id.* at 215.

The court determined that such writings constituted an assignment for collateral security. 30 N.Y.S.2d at 216.

Estate of Palmer, 53 Misc.2d 217, 278 N.Y.S.2d 352 (Sur. Ct. 1967), involved language considerably less explicit than the language in the present case. A beneficiary of an estate, in a letter to his brother stated:

> "Rec'd your check to-day in the amount of $1,000.00 which is to be applied against my share of mother's estate." *Id.* at 353.

The court held that this language constituted an assignment of the beneficiary's share of the estate. *See also Nunnemaker Transport Co.* v. *United California Bank*, 456 F.2d 28 (9th Cir. 1972); *Watson* v. *Stockton Morris Plan Co.*, 34 Cal. App.2d 393, 93 P.2d 855 (1939).

Therefore, under New York law the language in the April 30 and May 2, 1973 letters was sufficient to constitute an assignment for security of the Luxembourg time deposit. This result is in accord with the general test applied by the New York courts in determining whether an assignment exists.

> "The test is an inquiry whether the debtor [the obligor] would be justified in paying the debt, or the portion contracted about, to the person claiming to be assignee." *Fairbanks* v. *Sargent*, 117 N.Y. 320, 330, 22 N.E. 1039 (1889); *see Hinkel Iron Co.* v. *Kohn*, 229 N.Y. 179, 123 N.E. 113 (1920); *Donovan* v. *Middlebrook*, 95 App. Div. 365, 88 N.Y.S. 607 (1904); *Modern Kitchens Inc.* v. *Damiano*, 51 Misc. 2d 264, 273 N.Y.S. 2d 151 (Sup. Ct. 1966).

The present case clearly meets this test. If the Luxembourg affiliate had transferred the time deposit or its

proceeds to the New York Bank, AIBC would have had no claim against either. In fact, if the Luxembourg affiliate had alternatively transferred the time deposit to AIBC it would have been liable to the New York Bank since it had received notice of the New York Bank's security interest. *See Myers* v. *Albany Savings Bank, supra; Brown* v. *Empire City Savings Bank, supra.*

The district court stated that this test is circular. In the case of a naked instruction to an obligor to pay a third party the district court might be correct. However, where the language clearly gives a third party a security interest, as the two letters do here, the test is straight-forward and controlling.* In any event, the letters would still constitute an assignment under the test suggested in 3 Williston on Contracts § 428 at 161-62 (3d ed. 1960), cited by the district court.**

The district court's subsequent discussion of authorities [Opinion, A 147-151] is not addressed to the question of whether the April 30 and May 2, 1973 letters constituted an assignment. Rather it is addressed to an analysis of the instructions to the Luxembourg affiliate and a determination of whether these instructions constituted an assignment. Since the New York Bank does not claim that these instructions constituted an assignment of the time deposit, the court's analysis is inapplicable.***

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* This is the test which has been set forth by the highest New York courts. To disregard such a test because the federal court may question its propriety is to violate a cardinal rule in the area of choice of laws. *West* v. *American Telephone and Telegraph Co.*, 311 U.S. 223, 237 (1940). *See also Meredith* v. *Winter Haven*, 320 U.S. 228, 234 (1943); 1A Moore's Federal Practice ¶ 0.309[1] at 3325.

** Williston suggests the added element of looking at the "assignee" to determine if he would be entitled to retain the proceeds or if he is in fact only acting as the assignor's agent. (e.g., assignment for purpose of collection). Here it is clear that the assignment was for the purpose of security.

*** These instructions, of course, may be considered in conjunction with the April 30 and May 2, 1973 letters. Considered together, they serve to confirm the assignment evidenced by the letters.

Finally the district court suggested that the New York Bank's conduct upon receipt of the funds was incompatible with an assignment. [Opinion, A 152] Again the district court was mistaken because it failed to recognize that assignments need not be outright but may be for security purposes. The bookkeeping entries, *see McKenzie* v. *Irving Trust Co.*, 292 N. Y. 347, 359, *aff'd*, 323 U.S. 365, 371-72 (1954), through which the New York Bank debited the funds owed it and credited the amount received to AIBC's account are completely compatible with an assignment for the purpose of security.

Therefore, the exchange of the April 30 and May 2, 1973 letters assigned to the New York Bank a security interest in the Luxembourg time deposit. This security interest was perfected when made,* and the payment of the proceeds of the time deposit to the New York Bank may not be recovered as a preference.

C. A Security Interest In The Luxembourg Time Deposit Was Assigned To The New York Bank Pursuant To The 1970 General Pledge Agreement

The 1970 General Pledge Agreement [Ex. F. (E 181)] also served to give an assignment of a security interest in the Luxembourg time deposit to the New York Bank. *See also* Ex. 8 (E 10). The Agreement "assigned" to the New York Bank "all money and property that came into its custody and control." In the Agreement, AIBC agreed to:

> ". . . assign, transfer to, and pledge with Bank all money and property this day delivered to and deposited with Bank, and all money and property heretofore delivered or which shall hereafter be delivered to or come into the *possession, custody or control of Bank* . . . All money and property assigned, transferred to and pledged with Bank under this paragraph is hereinafter called 'collateral' . . ." [Emphasis supplied]

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* Though notice was given to the obligor neither it nor filing a financing statement were necessary and the payment of the proceeds of the time deposit is therefore not recoverable as a preference.

The district court recognized that this Agreement might very well constitute an assignment of the Luxembourg time deposit since the Luxembourg affiliate, which was in possession and control of the deposit, was acting as the New York Bank's agent. [Opinion, A 152] However, the district court found that pursuant to the Agreement the assignment terminated when the New York Bank lost "possession, custody or control" of the funds by transferring them to SCB for the purpose of exchange into dollars which were to be remitted to the New York Bank.

In so holding, the district court failed to apply subsequent language which explicitly provided for the exchange and transfer of the collateral:

> "At any time, without notice, and at the expense of the undersigned, Bank in its name or in the name of its nominee or of the undersigned may, . . . (3) *enter into* any extension, reorganization, deposit, merger, or consolidation agreement, or *any agreement in anywise relating to or affecting the collateral,* and in connection therewith may deposit or *surrender control of such collateral thereunder, accept other property in exchange for such collateral* and do and perform such acts and things as it may deem proper, and any money or property received in exchange for such collateral shall be applied to the indebtedness or thereafter held by it pursuant to the provisions hereof; . . . (5) insure, *process* and preserve *the collateral;* (6) *cause the collateral to be transferred to its name or to the name of its nominee;* (7) *exercise as to such collateral all the rights, powers and remedies of an owner;* . . ." [Ex. F. (E 181)] [Emphasis supplied]

Also, under New York common law and the New York *U.C.C.,* an assignee or a pledgee is not deemed to have lost possession when an item in which it has a security interest is delivered to a third party for a "temporary and specific" purpose. *Fairbanks* v. *Sargent,* 117 N.Y. 320, 334-35 (1889) (dealing with an assignment and a pledge); N. Y. U.C.C., § 9-306(3)(6); Point III, *infra.*

Therefore, the New York Bank received a valid assignment making it a secured creditor pursuant to both the exchange of letters and the 1970 General Pledge Agreement.

POINT II

In addition to the assignment, the first loan was secured by the pledge of the time deposit.

It is clear that under common law and the U.C.C.* a loan may be secured through a possessory security interest such as a pledge. *McCoy* v. *American Express Co.*, 253 N.Y. 477, 171 N.E. 749 (1930); U.C.C. § 9-305. The elements of a pledge are an intention to pledge collateral security and possession of the collateral by the pledgee or a third person for the purpose of securing a debt. Perfection of a pledge occurs with delivery of the collateral to the pledgee or a third person who receives notice of the pledgee's interest. 53 N.Y. Juris., *Secured Transactions* § 39 at 274. [Opinion, A 137-39]**

The district court found that the intention of the parties to pledge the Swiss franc time deposit to be lodged at the Luxembourg affiliate was clearly manifested in the exchange of letters between Silverston and the New York Bank dated April 30, 1973 and May 2, 1973 and in the New York Bank's internal loan authorization form. [Opinion, A 138]***

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* As noted in Point I, the U.C.C. does not govern the transfer of a security interest in a bank deposit. U.C.C. § 9-104(k) (McKinney's 1964).

Therefore, the law governing the pledge of a time deposit in New York is common law. However, this does not affect the result since the U.C.C., in dealing with possessory security interests, essentially adopted the common law rules. *See* Official Comment to U.C.C. § 9-305.

** The question of the validity of a pledge and its perfection are governed by state law. With respect to the pledge of the Luxembourg time deposit, the court found, and the parties agreed, that New York law was controlling.

*** It was also demonstrated by AIBC's own books and records. [*See* Exs. B (E 176), C (E 178), D (E 179), and E (E 180).]

The court found that the Swiss francs were delivered to the Luxembourg affiliate and held there in the form of a time deposit. It further found that the Luxembourg affiliate was notified of the New York Bank's security interest and was holding the time deposit as the New York Bank's agent. [Opinion, A 138-39, 180 n. 12]

However, the court held that in spite of the above facts there was not sufficient delivery of the time deposit to constitute perfection of the pledge.

The court premised this holding on two grounds:

1. The court concluded that the delivery of a "clean receipt" by the Luxembourg affiliate to AIBC gave AIBC the "deceptive appearance of complete ownership." [Opinion, A 137] For this reason the court found that the New York "Bank's agency relationship with the Luxembourg affiliate where the deposit was maintained [was] insufficient to constitute that delivery and possession of the property which is necessary to render a pledge valid and enforceable." [Opinion, A 142-43]

2. In addition, the court questioned whether the pledge of a time deposit can be perfected by any means other than by possession of an indispensable instrument. [Opinion, A 137, 139, 181 n. 14] The court then found that neither the New York Bank nor its agent, the Luxembourg affiliate, was in possession of an indispensable instrument.

A. Under New York Law, Creditors Are Not Entitled To Rely On A Bank Deposit Slip As Evidence Of Ownership Of A Deposit

The court observed that the policy behind the delivery requirement is to prevent the pledgor from obtaining a " 'false credit' from the apparent ownership of [the] item pledged." [Opinion, A 142] AIBC's possession of an indispensible instrument such as a passbook or certificate of deposit would have enabled AIBC to obtain a false credit. However, the time deposit receipt issued by the Luxembourg affiliate is not the same thing as a certificate of deposit. A certificate of deposit contains a promise by

a bank to pay on presentation of the certificate. The time deposit receipt here contained no such promise. [Ex. 3 (E 5)] It was nothing more than a receipt. The district court confused the legal significance of the two in its opinion. No certificate of deposit was ever issued by the Luxembourg affiliate.*

Under New York law, creditors are not entitled to rely on a bank deposit slip or receipt as evidence of ownership of a deposit. *First National Bank* v. *Clark,* 134 N.Y. 368, 372 (1892) is controlling. In that case, the New York Court of Appeals discussed the legal ramifications of a deposit slip:

> "The use of a deposit slip is well understood. It constitutes an acknowledgement that the amount of money named therein has been received. It is a receipt and nothing more. *No promise is made to pay the sum named on return of the paper;* nor is it expected, either by the depositor or depositary, that it will ever be presented to the bank again unless a dispute should arise as to the amount of the deposit, in which event it would become important as evidence. *It is not intended to furnish evidence that there remains money in the bank to the credit of a depositor,* but to furnish evidence as between depositor and depositary that on a given date there was deposited the sum named. *It may all, or nearly all, be checked out at the moment of making the deposit slip, but the depositor will not be refused it* [*the deposit slip*] *on that account, for long established usage has fixed its status in banking as a mere receipt,* an acknowledgement that the depositor placed the amount named therein on deposit. It

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* The district court's conclusion that the receipt [Ex. 3 (E 5)] did not constitute an indispensable instrument, Opinion, A 182 n. 15, is confirmed by *First National Bank* v. *Clark,* 134 N.Y. 368, 372 (1892). (See Tr. pp. 253-56, 279). *See also* U.C.C. § 3-104(2)(c); Modern Legal Forms, § 1921.3, 1396, 1397.1, 1397.2 (1964). The fact that it is referred to by some other name (a confirmation of deposit) does not alter its nature or significance. *First National Bank* v. *Clark, supra,* at 372.

> is not proof of liability, and it will not support an action against the bank." *Id.* [Emphasis supplied.]

The New York Bank is aware of no case dealing with the pledge or assignment of a time deposit in which a deposit slip was found to justify reliance by a creditor. Nor do any of the cases or authorities that discuss what is required to perfect a security interest in a bank account suggest that retention of the deposit slip by the secured party is a required element. *See Myers* v. *Albany Savings Bank,* 270 App.Div. 466, 60 N.Y.S.2d 477, *aff'd,* 296 N.Y. 562, 68 N.E.2d 866 (1946); *In re Hoffman's Estate,* 175 Misc. 607, 25 N.Y.S.2d 339 (Sur. Ct. 1940); *Walton* v. *Piqua State Bank,* 204 Kan. 741, 466 P.2d 316 (1970); L. Dennon, Transactions Under the Original and the Revised UCC, pp. 54-56 (1974). *See also Eichler* v. *Hillside National Bank,* 71 N.J. Super. 110, 176 A.2d 508 (1961); *M. M. Landy, Inc.* v. *Nicholas,* 221 F.2d 923 (5th Cir. 1955); *Watson* v. *Stockton Morris Plan Co.,* 34 Cal. App. 2d 393, 93 P2d 855 (1939); *McGuire* v. *Murphy,* 107 App. Div. 104, 94 N.Y.S. 1005 (4th Dep't 1905).

New York law is clear. A creditor is simply not entitled to rely on a bank deposit receipt as evidence of ownership of a deposit.* The reason, as pointed out in *First National Bank* v. *Clark,* is obvious. A time deposit, just like any other account, may be withdrawn prior to its maturity date.** In the event of withdrawal, the depositor retains his receipt.*** It is for this reason that creditors may not rely upon a receipt as evidence of ownership of the deposit. Only an indispensable instrument such as a passbook, which must be presented or surrendered upon withdrawal of the deposit, would justify reliance on the

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* The district court is bound by New York law in determining whether the delivery requirement of the pledge was met.

** In the case of a time deposit, early withdrawal may result in a reduction of the rate of interest.

*** Presumably, AIBC still retains the receipt it received from the Luxembourg affiliate for the time deposit in question, even though it has been in bankruptcy since 1974. It is astounding to suggest that this receipt could be used to deceive a creditor.

part of creditors. Where such an indispensable instrument does not exist, a creditor must confirm the purported owner's interest by communicating with the bank that has possession of the deposit. Any reasonable creditor following this practice would have contacted the Luxembourg affiliate and been notified of the New York Bank's security interest. Therefore, AIBC's possession of the deposit slip did not give it a "false credit", and the delivery requirement for a pledge was met.

B. The New York Bank's Telex Key And Telex Key Code Constituted An Indispensable Instrument. Their Possession Gave The New York Bank Possession And Control Of The Time Deposit

In international banking transactions, methods of depositing and obtaining funds which depend on the presentation of an indispensable instrument, such as a passbook or certificate of deposit, are simply impractical. Depositors do not have the time to travel thousands of miles, passbook in hand, to deposit or withdraw funds located at various banks scattered across the globe. For this reason, banks, in international transactions, have adopted a different system for the deposit and withdrawal of funds. A depositor is given, instead of a passbook, an ever-changing "test key" verifying code number. Through the use of this code number, a person may deposit and withdraw funds from his account via telex even though he is thousands of miles away. Without this system, the international transfer of funds would be at best impractical and at worst impossible. Therefore, the "test key" code serves the same purpose and function in transactions of this type as the traditional indispensable instrument does in every day banking transactions. [Tr. p. 251]

In the instant case, AIBC deposited funds with the Luxembourg affiliate via telex. As is the custom with transactions of this nature, the Luxembourg affiliate did not issue a passbook or any other standard kind of indispensable instrument—presentation of which would have entitled the holder to withdraw the funds. Instead, the Lux-

embourg affiliate relied on the "test key" code system. However, in this case, no "test key" code number was given to AIBC. The New York Bank retained for itself the particular "test key" code necessary for deposit or withdrawal of funds from the time deposit account lodged with the Luxembourg affiliate. AIBC could have sent telexes or letters to the Luxembourg affiliate but without the "test key" code, such telexes would not have affected the disposition of the funds.* [Tr. pp. 251-53, 272]

Comment e to the Restatement of Security, § 1 (1941), a section on which the district court relies heavily, provides in relevant part:

> "An indispensable instrument as used in the Restatement of this Subject means the formal written evidence of an interest in intangibles, so representing the intangible that the enjoyment, transfer or enforcement of the intangible depends upon possession of the instrument. If the instrument cannot be produced, the interest which it represents can be effectively asserted only by accounting for the absence of the instrument and obtaining as a substitute for it, either a duplicate or some form of court decree." *Id.*, Comment e.

Typical examples of an indispensable instrument include stock certificates, insurance policies, and bank books.

Applying this concept to the instant case establishes that there did exist an "instrumentality" which, although not a written document, clearly served the function of the traditional indispensable instrument. That instrumentality was the "telex key" code. Dependent on it was the "enjoyment, transfer, or enforcement" of the deposit. Without it, the interest it represented could be asserted only by accounting for the absence of the instrument and obtaining as a substitute for it either a duplicate or some form of court decree. This "instrument" was in the sole possession and control of the New York Bank. Furthermore, the rec-

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* *See also* Ex. Z (E 216), where SCB refused to transfer funds at AIBC's request because they had used the wrong "telex key" code number.

ord is clear that the Luxembourg affiliate was notified of the New York Bank's security interest. Once it was notified, AIBC simply could not affect the disposition of funds unless it used the New York Bank's "telex key" code or had its instructions confirmed by the New York Bank using the "telex key" code.* Had the Luxembourg affiliate paid out the funds without such confirmation, it would have been liable to the New York Bank.** *See Myers* v. *Albany Savings Bank, supra; Brown* v. *Empire City Savings Bank, supra.*

C. When A Bank Has Not Issued An Indispensable Instrument, A Pledge Of A Time Deposit May Be Perfected By Notifying The Bank Holding It Of The Secured Party's Interest

The district court pointed out that the primary purpose of the delivery requirement is to prevent the pledgor from deriving a "false credit from apparent ownership of [the] item pledged." [Opinion, A 142] The court then found that because of the existence of a "receipt" in the hands of AIBC, the New York Bank's agency relationship with the Luxembourg affiliate was insufficient to constitute delivery of the time deposit. [Opinion, A 142] Once it is recognized

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* Mail communications or telex communications without the "telex key" number or signature cards could not have affected the deposition of the funds. The mail communication from the Luxembourg affiliate to AIBC cited by the court did not involve the disposition of the funds. The one specifically referred to by the district court was simply a request for confirmation of the time deposit receipt mailed earlier. [Opinion, A 180, 181 n. 13; Ex. 4 (E 8)] Mail and telephone communications frequently exist between a bank and a depositor. The question at issue is not whether AIBC could communicate with the Luxembourg affiliate by other means but whether it could have affected "the enjoyment, transfer, or enforcement" of the deposit without use of the "telex key" code.

** Furthermore, the usual commercial practice for withdrawing the funds called for the use of the "telex key" code. Such commercial practice should govern the present transaction in determining whether the New York Bank had possession and control of the time deposit. Cf. N.Y. U.C.C., § 1-102(1) and (2) (McKinney's, 1964).

that a deposit receipt does not establish apparent ownership of a deposit and that creditors are not entitled to rely upon it, it becomes clear that the New York Bank's agency relationship with the Luxembourg affiliate was sufficient to constitute delivery of the time deposit. *See Creel* v. *Birmingham Trust National Bank,* 383 F. Supp. 871, 879 (N.D. Ala. 1974), *aff'd,* 510 F.2d 1363 (5th Cir. 1975).

Where a bank has not issued an indispensable instrument* and it receives notice of a third party's security interest, the result should be the same.** There is no basis in logic or law to distinguish between notice to the only party who has the power to issue an indispensable instrument and notice to a "holder" of the indispensable instrument.*** *See* Restatement of Security, § 8 (1941), Comment, p. 23; U.C.C. § 9-305. *Walton* v. *Piqua, supra,* is clearly distinguishable because in that case a passbook was issued, and the pledgee bank failed to obtain possession of it. [*See* Opinion, A 181 n. 14] In *Walton,* had the bank issued a passbook and then retained it, there would have been a valid pledge. As noted above, there is no reason to distinguish this from the situation where a bank retains possession and control of the passbook by never issuing it.**** *See also* Restatement of Security, § 6 (1941).

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* If the "telex key" code is not considered an indispensable instrument, then none was ever issued by the Luxembourg affiliate.

** In fact, a thorough reading of the opinion indicates that the district court might have so held if it had realized the true significance of the "receipt".

*** The Luxembourg Bank was clearly in possession and control of the time deposit and any indispensable instrument related to it.

**** Delivery of the property should be *all that the situation permits. Gins* v. *Mauser Plumbing Supply Co.,* 148 F.2d 974, 977 (2d Cir. 1945). *See also Israel* v. *Woodruff,* 299 F. 454, 456 (2d Cir. 1924). The primary objective is notice to third parties of the pledgee's security interest. That objective was met here, and the transaction should not be tested by the "literal and technical rules of pledge alone." *Sammet* v. *Mayer,* 108 F.2d 337, 339 (2d Cir. 1939). The agency relationship was, therefore, sufficient to secure the New York Bank. *See Creel* v. *Birmingham Trust National Bank,* 383 F. Supp. 871, 879 (N.D. Ala. 1974), *aff'd,* 510 F.2d 1363 (5th Cir. 1975).

In addition, unlike many choses in action, a bank deposit has as its basis tangible property—money.* Where an indispensable instrument has not been issued, a bank holding a deposit may be treated like a bailee holding goods, especially where the underlying Swiss francs are being purchased and sold like goods.

In re Midas Coin Company, 264 F. Supp. 193, *aff'd sub nom., Zuke* v. *St. John's Community Bank,* 387 F.2d 118 (8th Cir. 1968), is an example of a district court recognizing that the notice requirement was met and, therefore, treating money as "goods" in order to achieve a practical result. This case involved a pledge of gold coins to a bank as security for a loan. The trustee claimed that under the U.C.C. a security interest in money could not be affected by possession. The court distinguished between money when treated as a medium of exchange and money treated as a commodity.

> "The exclusion of 'money in which the price is to be paid' from the definition of goods does not mean that foreign currency which is included in the definition of money may not be the subject matter of a sales transaction. *Goods is intended to cover the sale of money when money is being treated as a commodity but not to include it when money is the medium of payment."* 299 F. Supp. at 197.

The court also compared the gold coins in question to a bank deposit. *Id.* The court concluded that the bank's

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* The district court pointed out that the New York Bank was given a security interest in the time deposit, that the parties must be found to mean what they say, and that this precluded a security in the Swiss francs. (Apparently, had the parties said Swiss francs, the New York Bank would have been secured.) Even assuming this literal approach is proper, *see contra, Frigaliment Importing Co.* v. *B.N.S. International Sales Corp.,* 190 F. Supp. 116 (S.D.N.Y. 1960), it still misses the point. A time deposit is composed of two elements—a depositor's right to the funds embodied in an "indispensable instrument" and the underlying funds without which the time deposit cannot exist. The district court pointed out that the courts have evolved the concept of "indispensable instrument". However, where one does not exist, possession of the other element of the deposit, the underlying funds should be sufficient to perfect a pledge.

physical possession of the funds was sufficient to perfect a security interest against the trustee. *See also In re Atlantic Times, Inc.*, 259 F. Supp. 820, 827 (N.D. Ga. 1966). This result is in accord with the purpose of the perfection requirement (notice to creditors) and business reality. This same result should be reached here. The New York Bank had sole possession of the "telex key" code. It had obtained an assignment to it of a security interest in the deposit. Its agent, the Luxembourg affiliate, which was notified of its security interest, was holding the time deposit and no indispensable instrument was issued to AIBC that would have permitted AIBC to obtain a "false credit" based on the deposit. This court should, therefore, reverse the district court and find that the New York Bank had a perfected security interest in the Luxembourg time deposit. If the district court's holding is affirmed, all current banking practices involving the assignment or pledge of time deposits would have to be completely revised. Banks here and abroad are accustomed to relying on notice communicated by telex and the mails. To hold that myriad other formalities must be observed before a bank could safely rely on notice from another bank regarding transactions secured by time deposits, would cause havoc in the banking industry.

D. The Time Deposit Located At The Luxembourg Affiliate Was A "Special Deposit" Similar To A Trust. Therefore, Payment Of The Proceeds To The New York Bank Did Not Constitute a Preference

Regardless of the pledge, the time deposit was in the nature of a "special deposit" so as to give rise to a trust relationship between the New York Bank and the Luxembourg affiliate. *Creel* v. *Birmingham Trust National Bank*, 383 F. Supp. 1363 (N.D. Ala. 1974), *aff'd*, 510 F.2d 1363 (5th Cir. 1975); *Rossman* v. *Blunt*, 104 F.2d 877 (6th Cir. 1939). Because of the trust relationship, the time deposit may not be treated as an asset of AIBC. Consequently, the transfer of the proceeds of the time deposit to the New York Bank would not constitute a preference. *See* Bankruptcy Act, § 70, 11 U.S.C. § 110 (1970).

In *Creel* v. *Birmingham Trust National Bank, supra,* the bankrupt, more than four months prior to the filing of the bankruptcy petition and pursuant to a settlement agreement incorporated in a court decree, deposited money with a bank to secure payment to two creditors. The bank acknowledged receipt of the funds and agreed to invest them in time deposits and United States obligations. The time deposits were scheduled to mature on the dates that payments were due under the settlement, and the proceeds were to be remitted to the two creditors. The trustee sought to recover those payments made within four months of bankruptcy as voidable preferences. The court rejected the trustee's claim on two grounds. First, the agency relationship created between the parties and the bank was sufficient to secure the creditors. Second, even though the parties had never mentioned a trust, a trust relationship had been created; and the trustee in bankruptcy was precluded from recovering the funds. *Creel* v. *Birmingham Trust National Bank, supra,* at 875, 879. Here, as in *Creel,* the Swiss francs were deposited to secure payment to a creditor. The funds were placed in a time deposit which was to mature on the date the loan was due; and the proceeds were to be remitted to the creditor. The Luxembourg affiliate was acting as the New York Bank's agent [Opinion, A 180 n. 12], and the arrangement could not be revoked without the New York Bank's consent.

POINT III

The transfer of the proceeds of the Luxembourg time deposit for conversion to dollars did not result in a loss of the New York Bank's security interest.

A pledge may be returned to the pledgor for a temporary or special purpose without any loss on the part of the pledgee of his secured interest. This includes returning the pledged item for purposes of sale or substitution. *Hickok* v. *Cowperthwait,* 210 N.Y. 137, 143, 103 N.E. 1111 (1913); *Fairbanks* v. *Sargent,* 117 N.Y. 320, 334-45, 22 N.E. 1039 (1889); *Harrison* v. *Merchants National Bank,*

124 F.2d 871, 874-75 (8th Cir. 1942); *Israel* v. *Woodruff*, 299 F.2d 454, 456 (2d Cir. 1924); Restatement of Security § 11(2) (1941). *See also McCoy* v. *American Express Co.*, 253 N.Y. 477, 483, 171 N.E. 749 (1930). Both the letters dated April 20 [Ex. A (E 174)] and May 2, 1973 [Ex. 1 (E 1)] and the General Pledge Agreement [Ex. F (E 118)] provide for the return of the collateral (the time deposit) for the temporary or special purpose of sale or substitution.

In *Hickok,* shares of common stock were pledged as security. Subsequently, these shares were returned to the pledgor for the purpose of having substitute certificates issued. The question before the court was whether the substitute certificates constituted a new and independent pledge. The court, quoting Justice Bradley's opinion in *Casey* v. *Cavoroc,* U.S. 467 (1877), held:

> "If the thing, however, is delivered back to the owner for a temporary purpose only, and it is agreed to be redelivered by him, the pledgee may recover it against the owner, if he refuses to restore it to the pledgee after the purpose is fulfilled. . . . So, if it be delivered back to the owner in a new character, as, for example, as a special bailee or agent. In such case, the pledgee will still be entitled to the pledge, not only as against the owner, but also as against third persons." 210 N.Y. at 143 [Emphasis supplied; citations omitted].

The pledgor was inferred to be acting as the agent of the pledgee because the pledged item was returned for "a temporary or special purpose."*

Harrison v. *Merchants National Bank,* 124 F.2d 871 (8th Cir. 1942), is a bankruptcy case that is precisely on point. *Harrison* involved a suit by a trustee in bankruptcy to set aside a pledge as preferential. The trustee con-

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* The implied agency is essentially a legal fiction adopted for the practical purpose of permitting the pledgee to release the collateral to the pledgor on a temporary basis. However, *see Hickok* v. *Cowperthwait, supra* at 144, stating that the pledgor need not be inferred to be a special bailee or agent of the pledgee.

tended that the Merchants National Bank had lost its lien on pledged poultry by surrendering it to the pledgor for the purpose of sale. Twenty percent of the proceeds of each sale were remitted to Merchants by check payable to the debtor and the bank jointly. The trustee sought to recover the proceeds of the sale that had been remitted to the bank.

> "All of the pledged poultry was pledged between May 28th and June 5th and was shipped thereafter in the regular course of business on purchase orders given by the Campbell Company. The loading and shipment of the poultry was in conformity with the agreement entered into between the parties. The warehouse receipts were at all times in the possession of the Bank. The poultry was in possession of the warehouse for the Bank. Any relationship of the pledgor to the shipments in question was merely that of an agent for the pledgee in effecting the sale of the pledged assets so as to apply the proceeds on the debt secured thereby. Everything which was done was mutually arranged by the pledgor and the pledgee in pursuance of a previous agreement. The prior arrangement between the parties was meticulously followed. The disposition of the property pledged under these circumstances does not constitute a waiver or a release of the lien of the pledgee. . . . Any return of pledged property to Haynes, if the transaction is to be characterized as such, was for a special purpose . . ." 124 F.2d at 874-75

It is, therefore, clear that if the time deposit had been turned over to AIBC for the "temporary and special" purpose of conversion to dollars, there would have been no loss of the New York Bank's security interest.*

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* In the present case, the collateral was also released pursuant to agreement for a specific purpose, *i.e.*, conversion into dollars. [Opinion, A 182, n. 17] The dollar proceeds were then transmitted to the New York Bank pursuant to the agreement between the parties entered into in May, 1973. The New York Bank's lien was continuous at all times.

However, the district court found that the proceeds of the time deposit were not turned over to AIBC but to a third party, SCB, who transmitted the dollar equivalent to the New York Bank. The district court found that SCB was not acting as the New York Bank's agent and that the pledge was, therefore, lost. [Opinion, A 182 n. 17] The cases, however hold that when collateral is delivered to a third party for the purpose of purchase or conversion into another form, the pledgee retains his interest even if the third party is the agent of the pledgor.*

Harrison is again on point. There the pledged poultry was shipped pursuant to the pledgor's order to a third-party purchaser. (The purchaser remitted the proceeds to the bank by check payable to the bank and the debtor jointly.) There was no indication that the purchaser had notice of the bank's security interest or was acting as the bank's agent. The court found that this did not result in a loss of the bank's security interest.

> "A pledgee may employ the pledgor as his agent to sell goods held in pledge and he does not lose his lien by allowing the pledgor to contract in his own name for the sale, or by delivering the goods on his order to the purchaser." 124 F.2d at 874

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* Since the return of the pledged item to AIBC for the "temporary and specific" purpose of exchange from Swiss francs to dollars would not have affected the New York Bank's security interest, the return of the pledged item to AIBC's agent should have the same result.

SCB was either acting as the New York Bank's agent, AIBC's agent, or simply as a third-party purchaser. If they were the New York Bank's agent, there would be no break in possession. If SCB was simply a third-party purchaser, the result would be the same even if the Swiss francs were sold to them in the name of AIBC. *Harrison* v. *Merchants National Bank, supra* at 874. The character of the third party who receives the pledged item should be irrelevant. [Opinion, A 182 n. 17] The important thing is that the item is delivered for a "temporary or specific" purpose. If anything, a less stringent test should be applied when a pledged item is returned for a "temporary or specific" purpose to a party who is not a pledgor.

Delivery of the pledged item to a purchaser [SCB] who remits the proceeds to the pledgee [the New York Bank] does not result in a loss of the pledgee's security interest.

In *Fairbanks* v. *Sargent, supra,* the collateral was surrendered to a third party for bonds. The bonds were delivered to the pledgor's agent who transferred them to the pledgee. The court found that the pledgee retained his security interest. 117 N.Y. at 333-35. Therefore, even if SCB is considered the agent of AIBC, the New York Bank retains its security interest.

However, SCB was acting as the New York Bank's agent. New York law is clear—a bank transmitting funds is the agent of the party sending them. 5 N. Y. Juris., *Banks and Trust Companies* § 227, p. 416 (1975).

Here, the Swiss Bank Corp. acting for the Luxembourg affiliate, issued the remittance instructions to SCB.

> "FR 3.309.997, 50 Att. Mr. Ribi. Instructions: Remit dollar equivalent to Wells Fargo Bank International Corp." [Ex. AD (E 221)]

The sender was, therefore, the Luxembourg affiliate acting for the New York Bank; and SCB was its agent.

However, regardless of whether SCB was the agent of the New York Bank or AIBC the result is the same. The New York Bank had a continuously perfected security interest in the time deposit and its proceeds.

This same result has been codified in §§ 9-306(3) and 9-304(5) of the New York Uniform Commercial Code. While Article 9 of the U.C.C. is not applicable to bank deposits, it is relevant at this point for two reasons: (1) when the funds were transferred to SCB to be exchanged for dollars, they ceased to be a bank deposit, and the U.C.C. may very well have become applicable,* and (2) these sec-

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* The revised U.C.C., § 9-104(1), explicitly states that the proceeds of a bank deposit are covered even though the deposit itself is not. New York has not yet adopted the revised U.C.C. However, there is nothing in the New York U.C.C. to indicate that it does not apply to proceeds of collateral simply because the initial collateral is excluded. The revision suggests that this was in fact the drafters' intent.

tions indicate that the authorities are uniform in guaranteeing the secured party a continuous security in the proceeds of collateral. U.C.C., § 9-306(3) provides, in pertinent part:

> "The security interest in proceeds is a continuously perfected security interest if the interest in the original collateral was perfected but it ceases to be a perfected security interest and becomes unperfected ten days after receipt of the proceeds by the debtor unless
>
> . . . .
>
> (b) the security interest in the proceeds is perfected before the expiration of the ten day period."

The Official Comment to § 9-306 makes it clear that if a party perfects his security interest in the proceeds of the collateral by taking possession of them within ten days, his security interest is deemed continuous for the purposes of § 60 of the Bankruptcy Act. 11 U.S.C. § 96 (1970). In the present case, the New York Bank received the proceeds of the Luxembourg time deposit on the same day that they were transferred to SCB. Therefore, under the U.C.C., its security interest was continuous.

The court's holding means that a bank account in a foreign currency can never be pledged as collateral with any safety if the funds were given up to a third party for exchange into another currency. If it were converted into dollars and remitted to a different country through a clearing house pursuant to instructions, the pledge would be "lost" or "broken".

Furthermore, no bank account in this country could ever be pledged as collateral if funds in that account had to be remitted through a clearing bank in order to be sent to the secured lending bank. In order to repay the loans by this means, possession of the funds would be "lost" or "broken". The only way of assuring the continuing validity of the pledge would be for the lending bank to send a representative to the bank holding the funds as collateral and return those funds in cash to the secured lending bank.

Such a result would be contrary to all present banking practices and would require some new method of transmitting funds between banks.

The district court's holding is simply incredible in light of commercial reality.

> "Regardless of whether a pledge to the New York Bank of the time deposit had been perfected in Luxembourg's hands, however, the assumed pledge expired when the time deposit matured on November 2. The subject of the pledge—the time deposit—had simply ceased to exist prior to the loan repayment to the New York Bank." [Opinion, A 143]

To hold that the pledge of a time deposit expires when that deposit matures, as though the underlying funds somehow had gone up in smoke, disregards basic banking practice. The funds in the matured time deposit are still there and may be the subject of a pledge.

In any event, both New York common law and the U.C.C. allow for the delivery of pledged collateral to the debtor or a third-party purchaser for the purpose of sale or exchange. Therefore, the New York Bank's security interest was continuous throughout the transaction.*

POINT IV

Repayment of the Bank's second loan did not result in a diminution of the bankrupt's estate.

AIBC had borrowed other funds from SCB. Silverston had personally guaranteed these advances. In June and July of 1973 AIBC issued irrevocable instructions to UCB to transfer the proceeds of the UCB Swiss franc time deposit to SCB at maturity.

On August 29, 1973, Silverston, in an apparent effort to avoid personal liability, arranged to divert the dollar pro-

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* Since the New York Bank retained a continuous security interest, it also never lost the "assignment" it received pursuant to the 1970 agreement. [Ex. F. (E 181); Opinion, A 142]

ceeds of the second forward foreign exchange contract to SCB, the funds which were to be used to repay the New York Bank's loan. [Ex. 19 (E 41), Q (E 196)]

Silverston sent SCB the following telex:

> ". . . (2) ucb Nov 19 paying you 3,182,557.83 Swiss francs representing 3,130,000 principal and 52,557.83 interest.
>
> (3) this sum of 3,182,557.83 sf sold you value 19 Nov 1973 per our conversation with Mr. Ribi and second telex of May 15 to Mr. Ribi attn.: at rate of 3.04 meaning for dlrs 1,046,894.05.
>
> (4) *kindly utilize these dollars to repay all dollar advances (and interest thereon) made to American IBC Corp.*" [Ex. 19 (E 41)] [Emphasis supplied]

The district court found that Swiss law governed the legal impact of this telex. [Opinion, A 169] The district court further found that this telex gave SCB a lien and a right of setoff on the dollar proceeds.* The result was that "no third party could have obtained an interest in those dollars superior to that of the Swiss Bank [SCB] after August 29, 1973.** [Opinion, A 170]

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* SCB was also secured by the assignment and pledge of the Swiss franc UCB time deposit. The assignment occurred when UCB was irrevocably instructed [Ex. 40 (E 103)] to pay the proceeds of the time deposit to SCB. Such irrevocable instructions constitute an assignment. *Adelman* v. *Centaur Corp.*, 145 F.2d 573, 575 (6th Cir. 1944); "After the instruction [to pay SCB] was issued, there was no possibility that the [UCB] time deposit might be assigned to the New York Bank by AIBC" [Opinion, A 163] *See also* Point I, *supra*. Since the funds that were the basis of this time deposit were lodged in UCB's account at SCB [Ex. 9, (E 11) Ex. 10 (E 13)] a pledge was also created. UCB could not have withdrawn the money and applied it elsewhere without SCB's consent. Since the process of converting the Swiss francs to dollars was also carried out by SCB, it had continuous possession of the funds.

** The opinion of the New York Bank's Swiss counsel was uncontroverted on this issue. (See the Kleiner affidavit (A 78) and deCapitani affidavit (A 36))

On November 19, 1973, SCB's lien on the dollars ripened into possession and title. At this point, as the district court recognized, the dollars became the property of SCB.

> ". . . [T]he alleged assignment to the Swiss Bank need not have been perfected prior to November 19 for the funds to be considered the Swiss Bank's property, perfection was accomplished on that date when the Swiss Bank obtained possession of the assigned funds." [Opinion, A 183 n. 18]

Furthermore, the trustee could not have recovered these dollars because under § 60(a) of the Bankruptcy Act, 11 U.S.C. § 96(a) (1970), this transfer of dollars became so far perfected that no attaching third-party creditor could have obtained an interest in the dollars superior to SCB. Section 60(a) (2) of the Bankruptcy Act provides, in pertinent part:

> "For the purposes of subdivisions (a) and (b) of this section, a transfer of property other than real property shall be deemed to have been made or suffered at the time when it became so far perfected that no subsequent lien upon such property obtainable by legal or equitable proceedings on a simple contract could become superior to the rights of the transferee. . . ."

Therefore, under § 60 of the Bankruptcy Act, the transfer must be deemed to have occurred on August 29, 1973, the date AIBC obtained its lien. *In re King-Porter Co.*, 446 F.2d 722, 730 (5th Cir. 1971). Since August 29, 1973 is more than four months prior to the bankruptcy petition of AIBC, the trustee could not recover these funds as a preference.

The district court's critical error was its failure to recognize that under § 60 of the Bankruptcy Act, the August 29, 1973 telex only needed to give SCB a lien that would have precluded third parties from obtaining a superior interest. The district court found that an outright transfer was necessary on August 29, 1973. [Opinion, A 170] This is simply not the law.

Therefore, when SCB transferred the dollars to the New York Bank, it was transferring its own dollars and not those of AIBC.* No diminution of the bankrupt's estate occurred. All that happened was that one creditor was substituted for another. There was no effect on the balance sheet of AIBC.

It is settled law that the essence of a preference is a depletion of the bankrupt's estate available to remaining creditors.** *Ricotta* v. *Burns Coal & Building Supply Co.,* 264 F.2d 749 (2d Cir. 1959); *LaBour* v. *Allen,* 165 F. Supp. 471, 474 (W.D. Mich. 1958); Opinion, A 168. The cases are also uniform in holding that payment of a creditor by a third party out of the third party's own funds does not constitute a diminution of the bankrupt's estate.*** At most, one creditor is simply replaced with another, while the balance sheet is unaffected. **** *In re*

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* Even if the dollars had not become the property of SCB on November 19, 1973, there still would have been no diminution because the liens would have been continuous. *Ricotta* v. *Burns Coal & Building Supply Co., supra. See also In re Erie Forge & Steel Corp., supra; Bertram* v. *Citizens National Bank,* 283 F. 2d 783 (6th Cir. 1960); U.C.C. § 9-302(2); 3 Collier ¶ 60.51A at 1050.11. SCB's lien began on August 29, 1973. When the Chase Manhattan Bank released the dollars on behalf of SCB to the New York Bank, the New York Bank immediately acquired a lien pursuant to either the "1970 Agreement" [Ex. F (E 181)] or the Bank's right of setoff. *Hamm* v. *Hamm,* 87 N.Y.S. 2d 47 (Sup. Ct. 1949).

** The burden of proving that the estate has been diminished is on the Trustee. *Dinkelspiel* v. *Weaver,* 116 F. Supp. 455, 459 (W.D. Ark. 1953).

*** The Trustee has the burden of proving that the property belonged to the bankrupt company. *I-T-E Circuit Breaker Co.* v. *Holzman,* 354 F.2d 102, 107 (9th Cir. 1965).

**** An exception to this rule is if the debtor exercises control over the third party's funds by designating within four months of the bankruptcy petition which creditor is to receive them. *Inter-State National Bank of Kansas City* v. *Luther,* 221 F.2d 382, 392 (10th Cir. 1955); *Aulich* v. *Largent,* 295 F.2d 41, 52 (4th Cir. 1961); *Smyth* v. *Kaufman,* 114 F.2d 40, 42 (2d Cir. 1940). AIBC initially instructed SCB on May 15, 1973 to pay the dollars to the New York Bank. However, on August 29, 1973, AIBC rescinded these instructions and told SCB to keep the dollars. Payment to the New York Bank occurred in spite of AIBC's efforts to divert the dollars. Therefore, this exception is inapplicable.

Erie Forge & Steel Corp., 456 F.2d 801 (3d Cir. 1972); *Ricotta* v. *Burns Coal & Building Supply Co., supra; Grubb* v. *General Contract Purchase Corp.*, 94 F.2d 70 (2d Cir. 1938); *LaBour* v. *Allen, supra;* 3 Collier, ¶ 60.26, p. 880.

This is still the case even if the funds originated with the bankrupt as long as the initial transfer was not a preference. *In re Erie Forge & Steel Corp.*, 456 F.2d 801 (3d Cir. 1972). The facts in *Erie Forge* are similar to those in the present case. In *Erie Forge,* two banks participated in a loan on a 60 percent to 40 percent ratio. They agreed that in the event either of them received a payment which would alter this ratio, that bank would purchase a sufficient interest in the notes payable by the debtor to the other bank to maintain the 60/40 relationship between the banks. Within the four month period, one bank properly set off funds in an account maintained by the debtor. As a result, it purchased a participation in the second bank's loan pursuant to the agreement to maintain the 60/40 ratio. The trustee in bankruptcy tried to recover the funds transferred in purchasing the participation, claiming a preference. The court refused on two separate grounds: (1) the funds transferred were not the property of the bankrupt, and (2) there was no diminution of the bankrupt's estate.

> "Thus, Erie Forge's balance sheet would remain unaffected by the interbank transaction and the conclusion that the debtor's estate was not depleted naturally follows." 456 F.2d at 805-06

Here, just as in *In re Erie Forge & Steel Corp.*, the initial transfer of dollars by AIBC to SCB was not preferential.* Therefore, the second transfer by SCB of its own dollars did not result in a diminution of AIBC's estate. At most, one creditor was substituted for another. The balance sheet of AIBC was not affected.

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* The transfer must be deemed to have occurred on August 29, 1973 when SCB obtained its lien. This was more than four months prior to AIBC's petition in bankruptcy, and therefore not preferential.

Upon receipt of the dollars on November 19, the New York Bank credited and simultaneously debited the dollars from AIBC's account. In *McKenzie* v. *Irving Trust Co.*, 292 N.Y. 347, 359, *aff'd*, 323 U.S. 365, 371-72 (1945), the New York Court of Appeals held that bookkeeping entries of this type made to reflect a loan repayment do not constitute a return of the funds to the bankrupt.

> ". . . The book entries of the Bank on November 28th by which the check received by the contractor [the bankrupt] from the government were deposited in the account of the contractor and the check of the contractor to the order of the bank in payment of indebtedness to the bank, merely constituted a record of the transaction in compliance with the directions of the contractor." 292 N.Y. at 359

However, if it is assumed for the sake of argument that these bookkeeping entries did constitute a return of the funds to AIBC, then the New York Bank in debiting the amount was properly exercising its right of setoff. *See New York County National Bank* v. *Massey*, 192 U.S. 138, 145-48 (1904); *Citizens National Bank* v. *Lineberger*, 45 F.2d 522, 527 (4th Cir. 1930) *See also* 4 Collier ¶ 68.16. The only restrictions are that the deposits must be made in a general account and be applied in good faith and in the ordinary course of business. *See Joseph F. Hughes & Co.* v. *Machen*, 164 F.2d 983, 987 (4th Cir. 1947), *cert. denied*, 333 U.S. 881 (1948). The trustee cannot have it both ways. If the funds were returned to AIBC then the New York Bank was properly exercising its right of setoff.*

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* This would also be true for the first transaction.

POINT V

The New York Bank did not suspect, let alone have reasonable cause to believe, that AIBC was insolvent.

Under § 60(b) of the Bankruptcy Act, 11 U.S.C. § 96(b) (1970), the burden is on the Trustee to establish that the creditor who was preferred had "reasonable cause to believe" that the debtor was insolvent. Mere suspicion of insolvency is not enough. *Lang* v. *First National Bank,* 215 F.2d 118 (5th Cir. 1954). There is a presumption of good faith on the part of a creditor, and the Trustee must rebut this presumption. *Roche* v. *New Hampshire National Bank,* 192 F.2d 203 (1st Cir. 1951); *Vance* v. *Dugan,* 187 F.2d 605 (10th Cir. 1951).

A. The New York Bank Had No Reason To Believe That AIBC Was Insolvent Before It Lent AIBC $2 Million Or At Any Time Prior To Repayment Of The Loans

The record establishes that in April, 1973, the New York Bank was aware that AIBC was having a dispute about assets with former officers in Colombia; and on May 1, 1973, it learned that a settlement had been proposed and that it was something AIBC "could live with" [Tr. p. 50]:

> "While a debtor's assurance of solvency, such as the letter appellee received from the prestigious company officer who had arranged for him to be hired, is not necessarily controlling . . . it is sufficient to negate further inquiry when the creditor is without reason to suspect either the integrity, or the accuracy of the information of the informant." *Seligson* v. *Roth,* 402 F.2d 883, 887 (9th Cir. 1968)

Here, Silverston was a valued customer; and the New York Bank considered him a man of integrity. [Tr. p. 191] Furthermore, Silverston himself had brought the dispute to its attention. It had no reason to doubt him when he informed it of the proposed settlement and said it was something AIBC could live with.

Courts have held that an inquiry of the debtor is not sufficient only when his integrity is suspect or when other

surrounding evidence is strongly indicative of insolvency. For example, in *Employers Mutual Casualty Co.* v. *Hinshaw,* 309 F.2d 806, 808 (8th Cir. 1962), all other information received by the creditor was "negative or adverse to the financial solvency of the bankrupt." This clearly was not the case here.

The district court acknowledged that the Trustee had not established that the proposed settlement would have left AIBC insolvent. On the balance sheet, the loss of assets would appear to be offset by the discharge of AIBC's guarantee. [Opinion, A 176 n. 5; Exs. 14 (E 20), 50 (E 128)] However, the district court found that the New York Bank should have known that the settlement was not concluded either because it agreed to act as escrow agent or that it at least knew the proposal was highly contingent. [Opinion, A 177 n. 6]

The New York Bank did not agree to act as escrow agent [Tr. p. 159; Opinion, A 177 n. 6], nor was it aware that the settlement was not concluded. [Tr. pp. 158, 159]

Completely apart from the conclusion that the settlement was not concluded, the Trustee still failed to prove that the New York Bank knew that the dispute involved $3 million in assets that had been misappropriated by Lara and Ospina. Only if the Trustee established that the New York Bank was aware of the seriousness of the dispute, and that it was unlikely to be resolved, would the New York Bank be obligated to investigate further.* Furthermore, the

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* Other than the Trustee's failure of proof, the basic problem is that the policy behind charging a creditor with the knowledge that a diligent inquiry would have revealed, is simply not relevant before the creditor makes the loan.

The purposes of this test is to "preclude a creditor from deliberately closing his eyes so as to remain in ignorance of the debtor's condition." *In re Hygrade Envelope Corp.,* 366 F.2d 584, 586 (2d Cir. 1966). Here, the New York Bank learned of the dispute before it lent AIBC $2 million. Far from "deliberately closing his [its] eyes," it would have welcomed any information on AIBC's financial status. Banks prefer not to lend money to insolvents.

Trustee has never proved that AIBC was insolvent in April, 1973, before the New York Bank made the loan.

The dispute between AIBC and the Lara group came to the New York Bank's attention in early 1973. It learned of the proposed settlement on or about May 1, 1973. Therefore, any investigation would have occurred in April or May of 1973. The Trustee failed to establish that AIBC was insolvent prior to June 1, 1973. [Opinion, A 125; Ex. 53 (E 165)] In fact, Silverston's own testimony indicates that AIBC's financial position deteriorated with each passing month. [Tr. p. 43] Therefore, it cannot be presumed that if AIBC was insolvent in June, it was insolvent earlier in May. *International Minerals & Chemical Corp.* v. *Moore,* 361 F.2d 849, 854 (5th Cir. 1966); 1 Collier ¶ 1.19(5) at p. 130.8. Since the Trustee has not established that AIBC was insolvent at the time the New York Bank would have investigated, he has failed to meet his burden of proof.

B. The New York Bank Did Not Have Reasonable Cause To Believe That AIBC Was Insolvent On November 2 And November 19, 1973, The Dates It Was Paid

The test is not whether the New York Bank had "reasonable cause to believe" that AIBC was insolvent in April, 1973, but whether it had "reasonable cause to believe" it was insolvent in November, 1973, at the time of the loan repayments. *Lang* v. *First National Bank,* 215 F.2d 118 (5th Cir. 1954); *Lee* v. *State Bank and Trust Co.,* 38 F.2d 45 (2d Cir. 1930). The district court met this requirement by finding that the New York Bank had a duty to investigate AIBC in May, 1973 and that this duty carried over to November, 1973.

In essence, what the court is requiring is that a bank, upon notice of any problem, no matter how remote or contingent, monitor the affairs of the debtor. This monitoring would not be satisfied by merely checking with the debtor, himself, (for the court found the New York Bank's checking with the debtor insufficient), but rather would require checking with all parties who might be in any way in-

volved, no matter where they may be geographically. The court leaves open what the bank should do if the parties cannot be reached or if the parties refuse to cooperate with the bank's inquiries.

Moreover, the court's decision would require a bank to be 100% certain of each and every aspect of a debtor's business and related affairs before making a loan; if not, the bank would be required to continue constant in depth monitoring of the debtor after the loan is made or else face the prospect of a loss of the loaned funds to the bankruptcy trustee.

In this case, the New York Bank did monitor AIBC's affairs. It obtained AIBC's certified financials.* It obtained "clear" Dun & Bradstreet reports on AIBC. It checked with other banks and prepared general credit reports called CR 38 and 39 reports. [Tr. pp. 255-58; Exs. 54 (E 166), 26 (E 73)] These procedures revealed no negative information about AIBC. As both a matter of practice and law, this should be sufficient.

International Minerals & Chemical Corp. v. *Moore,* 361 F.2d 849 (5th Cir. 1966), impliedly rejected the theory that a creditor has an ongoing duty of investigation. There the court found that even if the creditor (International) had reasonable cause to believe the debtor was insolvent in 1960, this did not mean it had "reasonable cause to believe" the debtor was insolvent in 1961, when it was paid.

> "Even the fact, if it be a fact, that in 1959 or early 1960 International may have had reason to suspect that a transfer *then* would have effected a preference, is not to say that such a belief, or reasonable cause therefor, would still exist in December 1961 without cogent proof." *Supra* at 853-54.

If knowledge of insolvency at one point in time creates an ongoing duty to investigate, as the district court sug-

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* The fact that AIBC was a few months late in forwarding its 1973 financials is not unusual. Small private companies are often somewhat late in forwarding their financial statements.

gests, then knowledge of insolvency should have been imputed to the creditor in *International Minerals & Chemical Corp.* v. *Moore, supra.* However, the circuit court refused to do so and reversed that district court's finding that "reasonable cause to believe" existed.

Other factors in *International* are closely parallel to the present case: (1) a memorandum prepared by a sales manager of the creditor suggesting a belief that the debtor was not creditworthy and expressing a need for collateral to secure the money owed; (2) a credit report by Dun & Bradstreet received by the creditor indicating that the debtor's business was financed primarily on a credit basis with encumbrances "moderately heavy"; and (3) a statement in the same report noting that certified financial information about the debtor was lacking so as to make it impossible to evaluate the present status of the debtor's business for credit purposes. Additionally, the court noted that the debtor had failed to pay notes owing to the creditor at maturity so as to necessitate a financing arrangement culminating in repayments which included those constituting the subject matter of the litigation in question. Despite these facts, the court held that there was no "reasonable cause to believe" the debtor was insolvent.

The courts have consistently held that facts, such as those present here, simply are not sufficient to establish "reasonable cause to believe" that a debtor is insolvent as a matter of law. *Carroll* v. *Holliman,* 336 F.2d 425 (10th Cir. 1964), *cert. denied,* 380 U.S. 907 (1965); *Hoffman* v. *First National Bank,* 392 F.2d 202 (5th Cir. 1968); *Moran Brothers, Inc.* v. *Yinger,* 323 F.2d 699 (10th Cir. 1963); *Lang* v. *First National Bank,* 215 F.2d 118 (5th Cir. 1954); *In re Salmon,* 249 F. 300 (2d Cir. 1917); *Salter* v. *Guaranty Trust Co.,* 140 F. Supp. 111 (D. Mass. 1956), *modified on other grounds,* 237 F.2d 446 (1st Cir. 1956).

"Reasonable cause to believe," in the instant case, is premised on information that the New York Bank failed to investigate, not on what the New York Bank knew. The question at issue is not the adequacy of the New York

Bank's credit investigations (as the Trustee apparently contends), but whether there existed "reasonable cause to believe" that AIBC was insolvent. A creditor cannot be charged with 20-20 foresight as to the impact of each and every problem which a borrower may have on that borrower's financial statement. To do so would make the standard one of "reasonable cause to suspect," and this is not the law.

As the court noted in *Security-First National Bank of Los Angeles* v. *Quittner*, 176 F.2d 997, 999 (9th Cir. 1949), a creditor "should not be required to make inquiries which could appear necessary after he has hindsight of later events." It is exactly such hindsight that has been applied in the present case. [Opinion p. 132]

As the Supreme Court aptly commented in *Grant* v. *National Bank*, 97 U.S. 80 (1877):

> "A man may have many grounds of suspicion that his debtor is in failing circumstances, and yet have no cause for a *well-grounded* belief of the fact. . . . To overhaul and set aside all [the debtor's] transactions with his creditors, made under such circumstances, because there may exist some grounds of suspicion of his inability to carry himself through, would make the bankrupt law an engine of oppression and injustice. It would, in fact, have the effect of producing bankruptcy in many cases where it might otherwise be avoided." *Id.* at 81-82. *See also Lang* v. *First National Bank, supra* at 121.

If any bank's loan relations with its clients were examined with the intensity that is applied in an after-the-fact ligtigation such as the present one, no loan would ever be made.

CONCLUSION

For the reasons stated in this brief the district court's decision should be reversed.

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

ALAN B. MILLER, as Trustee in Bankruptcy of AMERICAN IBC CORP., Bankrupt,

Plaintiff-Appellee,

against

WELLS FARGO BANK INTERNATIONAL CORP.,

Defendant-Appellant.

State of New York,
County of New York,
City of New York—ss.:

IRVING LIGHTMAN, being duly sworn, deposes and says that he is over the age of 18 years. That on the 12th day of April, 1976, he served two copies of Brief of Defendant-Appellant on Weil, Gotshal & Manges, Esqs., the attorneys for Plaintiff-Appellee by delivering to and leaving same with a proper person in charge of their office at 767 Fifth Avenue in the Borough of Manhattan, City of New York, between the usual business hours of said day.

Irving Lightman

Sworn to before me this
12th day of April, 19 76

Courtney J. Brown

COURTNEY J. BROWN
Notary Public, State of New York
No. 31-5472920
Qualified in New York County
Commission Expires March 30, 1978